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FM AMEMBASSY ASTANA
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4904
INFO RUCNCIS/CIS COLLECTIVE 1366
RUEHZL/EUROPEAN POLITICAL COLLECTIVE
RUCNCLS/ALL SOUTH AND CENTRAL ASIA COLLECTIVE
RUEHBJ/AMEMBASSY BEIJING 0743
RUEHKO/AMEMBASSY TOKYO 1446
RUEHUL/AMEMBASSY SEOUL 0430
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RHMFIUU/CDR USCENCOM MACDILL AFB FL
RUEHAST/USOFFICE ALMATY 1312

UNCLAS SECTION 01 OF 03 ASTANA 000450

SENSITIVE
SIPDIS

STATE FOR SCA/CEN, EEB/ESC
STATE PLEASE PASS TO USTDA FOR DAN STEIN

E.O. 12958: N/A

TAGS: [PGOV](#) [ECON](#) [EPET](#) [EINV](#) [KZ](#)

SUBJECT: KAZAKHSTAN: A BILLION-DOLLAR QUESTION

REF: (A) ASTANA 0317 (B) 08 ASTANA 2259 (C) ASTANA 1868

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¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (SBU) SUMMARY: On March 13, the director of Chevron's operations in Eurasia told the Ambassador that Tengizchevroil (TCO), in which Chevron has a 50% share, has come under "renewed attack" from the government over sulfur storage practices in Tengiz. Jay Johnson, Managing Director of Chevron's Eurasia Business Unit (protect throughout), said the issue has "escalated dramatically" since February and has the potential to become a multi-billion dollar claim, which Chevron would dispute via international arbitration if necessary. Johnson said local authorities have already frozen one TCO bank account and he expects them to seize other assets soon. In a related development, TCO sent a letter of protest last week to the British Embassy, which characterized sulfur as a "waste" and not a "product" on a website and in official correspondence promoting their sulfur management program in Kazakhstan. According to recent amendments to the Tax Code, sulfur is now considered a "waste" and its production is subject to taxation and penalties. Also this week, Royal Dutch Shell, which leads offshore development of the Kashagan oil field, hosted a meeting with U.S., UK, and Canadian Embassy Officers to plan for a sulfur management conference in Astana in July. The purpose of the conference is to present a legislative package that meets international standards and to promote sulfur in value-added products such as sulfuric acid, fertilizer, concrete, and asphalt.
END SUMMARY.

2007 COURT RULING PUNISHES TCO

¶3. (SBU) According to Chevron's Johnson, in November 2007, a court in Atyrau oblast ordered TCO to pay \$342 million for environmental permits for the storage of sulfur at Tengiz. Johnson said this decision represented a change in government policy. Previously, the government had based its fee on TCO's annual sulfur production and storage. With this ruling, however, the government calculated its

fee based on the cumulative amount of sulfur produced and stored at Tengiz since 1993, and calculated the amount (erroneously, according to Johnson) as if TCO did not pay for sulfur stored in previous years. Johnson also said that TCO initially applied for a permit to pay for sulfur storage on a cumulative basis, but was denied and told permits would only be issued on an annual basis. Johnson told the Ambassador that TCO protested the government's assessment methods at the time, but paid the fine in order to maintain production.

TCO DISPUTES ADMINISTRATIVE PENALTY

14. (SBU) In February 2008, Johnson said TCO was surprised to learn that the Atyrau court had levied a \$310 million administrative penalty on TCO, on top of the \$342 million fee the company had already paid. TCO refused to pay the penalty, appealed the ruling, and protested directly to First Deputy Prime Minister Umirzak Shukeyev, who "tacitly agreed" that the government would not pursue the matter further. Johnson said Shukeyev has been helpful keeping this issue "in a holding pattern" and has intervened personally on at least three occasions to block the Atyrau court from holding a hearing that would force TCO to pay the administrative penalty.

ATYRAU COURT DENIES APPEAL, FREEZES ASSETS

15. (SBU) Nevertheless, Johnson told the Ambassador that the Atyrau court convened last week and rejected TCO's appeal -- without notifying or inviting TCO, presumably to prevent the company from appealing for assistance to Shukeyev. (NOTE: Johnson said he wasn't surprised by the court decision, which he suspected was pre-determined. He told the Ambassador that TCO's lawyers have gone to court in other cases and have seen the judge's ruling already signed, sealed, and delivered, before the hearing even begins. END NOTE). On March 12, soon after the court ruling, Johnson said local authorities froze one TCO bank account and seized the assets, which

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amounted to less than \$100, since the account is no longer actively used. "Once they realize their mistake," Johnson said, "they'll come after our active accounts." He added that TCO does not have sufficient cash on hand to pay the administrative penalty, even in its offshore accounts.

TAX CODE AMENDMENT DEFINES SULFUR AS "WASTE"

16. (SBU) On February 21, parliament attached a rider to the Islamic Banking Law that amended the Tax Code, classified sulfur as "industrial waste," and established a formula for calculating sulfur storage penalties. Johnson said that if the tax authorities apply the formula based on accumulated volumes at Tengiz, the charge could amount to more than \$5 billion. (NOTE: According to the amended Tax Code, the fee for storing one ton of sulfur would be 3.77 times the "monthly estimated unit," which is determined annually in the budget and is currently 1,273 tenge, or \$8.50. Therefore, TCO would be forced to pay \$32.00 per ton of sulfur. END NOTE). Johnson contends that the new law violates a protocol the government signed with TCO in 2008, agreeing that sulfur would be treated as a product and not "waste", as well as the bilateral investment treaty governing Chevron's investment in TCO. "The irony," said Johnson, "is that the government has amended the Tax Code to target TCO, when it has already determined that TCO's tax stability clause means the Tax Code does not apply to TCO." Johnson said that Chevron CEO Dave O'Reilly has already written to President Nazarbayev to protest the government's action and has requested a face-to-face meeting at the end of March.

TCO ORDERED TO RE-FILE TAX RETURNS

17. (SBU) In addition to losing the court appeal and having sulfur classified as waste, TCO learned this week that the central government's Tax Committee has ordered the company to re-file its tax returns for 2003-2006, based on a re-calculation of the fee for TCO's cumulative sulfur storage at Tengiz. As Johnson said, "We simply cannot do that. Each year, we must declare that our tax return is accurate and correct. If we re-file the returns, it would be an admission of wrong doing, which would open us up to other

finances and penalties." When asked to speculate why the government seemed to be increasing pressure on TCO at this time, Johnson did not hesitate: "This is money-driven," he said. "The head of the Presidential Administration, Aslan Musin, was the Akim (governor) of Atyrau oblast when all this started. He launched the original battle and now he's in a much stronger position to carry it out."

THIS COULD GET UGLY

18. (SBU) Although he stopped short of requesting the Ambassador to intervene, Johnson said that Chevron may indeed ask for U.S. government assistance if the parties cannot resolve this issue soon.

In the meantime, he warned, "Things are going to get ugly. TCO plans to make massive layoffs of working and office staff this month, in part to send a message to the government, but also simply because we cannot afford to operate under these conditions." Johnson added that if TCO and the government cannot resolve the issue in private, Chevron will reflect the cost and uncertainty of the tax dispute in its next quarterly filing with the U.S. Securities and Exchange Commission. That would generate unwelcome negative publicity, he speculated, and could adversely affect Chevron's stock value and Kazakhstan's investment climate.

TCO PROTESTS UK CHARACTERIZATION OF SULFUR

19. (SBU) On March 5, TCO's General Director Todd Levy sent a letter to the British Ambassador to protest the British Embassy's characterization of Tengiz sulfur as "waste" on their website and in a Russian-language translation of a letter to Vice Minister of Energy Askar Batalov. The British Embassy website claimed that "the high level of sulphur in Tengiz oil poses a negative impact on oil production" and said that "the (sulfur) wastes are currently stored in uncovered areas causing considerable environmental damage."

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(NOTE: Chevron's Johnson suspected that the British Embassy may have been unduly influenced by the British Sulfur Consultancy Group they have retained to provide technical assistance on sulfur management. He also suggested that this group may have ties to Royal Dutch Shell, a competitor of Chevron's. END NOTE). The British Embassy subsequently pulled the offending article from their website and sent a Diplomatic Note to the Ministry of Energy correcting the Russian-language letter. The U.K. government will continue to fund training and technical assistance in sulfur management in Kazakhstan, with a focus on developing value-added products using sulfur and sulfuric acid.

SULFUR CONFERENCE IN JULY

110. (SBU) On March 11, Energy Officer attended a meeting with Canadian and British embassy officials at the local headquarters of Royal Dutch Shell. The purpose was to discuss planning for a conference in July on sulfur management. (NOTE: Shell was the lead sponsor for a similar conference held in Astana in July 2008. END NOTE). Neil Carmichael, Shell's General Manager for Central Asia, said they would welcome TCO's participation in the event this year, but said bluntly, "We don't want an argument between TCO's lawyers and the government, like we had last time." Shell proposed, and the embassy officers from Canada and Great Britain agreed, that this year's conference should avoid discussion of environmental and tax issues and instead focus on developing a legislative package that meets international standards, potentially based on the Canadian model, and on the use of sulfur in value-added products such as fertilizer, sulfuric acid, concrete, and asphalt.

111. (SBU) COMMENT: Sulfur is a big deal in Kazakhstan, and not only because more than 8 million tons of it are stacked up at Tengiz in pallets the size of football fields. It is a big deal because it has the potential to make a lot of people very wealthy, whether through trading contracts or through tax payments and administrative penalties. Sulfur directly affects the operational, employment, and investment decisions of Chevron, still the largest single investor in Kazakhstan, and as such it is an issue that the U.S. government should continue to monitor closely. Due to the nature of Kazakhstani crude, as oil volumes go up, sulfur mounds will grow. Once Kashagan and other new fields come on line, the issues

surrounding sulfur will only become more complex, contentious, and critical. END COMMENT.

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